DEPARTMENT OF STATE REVENUE

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Letter of Findings: 02-20110565
Indiana Corporate Income Tax
For Tax Years 2007 and 2008

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ISSUES

I. Corporate Income Tax–Exclusion of Entities.

Authority: IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-3-2-12; IC § 6-3-4-14; IC § 6-8.1-5-1; 45 IAC 3.1-1-111; Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999); Indiana Dep't of Revenue v. Endress & Hauser, Inc., 404 N.E.2d 1173 (Ind. Ct. App. 1980).

Taxpayer protests the Department's decision to exclude two of its subsidiaries from its consolidated income tax return.

II. Corporate Income Tax–Net Operating Losses.

Authority: IC § 6-8.1-5-1.

Taxpayer protests that the computation of additional tax did not consider net operating losses available to Taxpayer.

III. Corporate Income Tax–Promulgation of Regulations.

Authority: IC § 6-3-2-2; IC § 6-8.1-3-3.

Taxpayer protests that the Department was not authorized to assess additional tax absent the promulgation of a regulation.

IV. Corporate Income Tax–Estimated Tax Penalty.

Authority: IC § 6-3-4-4.1.

Taxpayer protests the imposition of a penalty.

STATEMENT OF FACTS

Taxpayer is a parent corporation doing business in Indiana and other states. Taxpayer files its Indiana adjusted gross income tax returns on a consolidated basis with its subsidiaries. Taxpayer filed its 2007 and 2008 Indiana corporate income tax returns on a consolidated basis. In particular, Taxpayer included two subsidiaries (Sub L and Sub G) on these returns.

The Indiana Department of Revenue ("Department") determined that Taxpayer had included Sub L in its consolidated Indiana adjusted gross income tax returns despite the Department's contention that Sub L did not have Indiana source income and excluded Sub L from the consolidated returns. Further, the Department determined that Sub G's inclusion in Taxpayer's consolidated income tax return resulted in an unfair reflection of Taxpayer's overall income. Thus, the Department separated Sub G from the remainder of Taxpayer's consolidated return and determined Sub G's tax separately from the remainder of Taxpayer.

Taxpayer protested these adjustments. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Corporate Income Tax–Exclusion of Entities.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

A. Sub L.

The Department removed one of Taxpayer's out-of-state subsidiaries (Sub L) from Taxpayer's consolidated Indiana income tax return. The Department removed Sub L because the Department determined that Sub L did not have Indiana source income from Taxpayer's consolidated adjusted gross income tax returns. Sub L was excluded from the returns because it did not meet the Indiana source income requirement found in IC § 6-3-4-14. The out-of-state subsidiary reported zero Indiana property, payroll, and sales.

Pursuant to IC § 6-3-4-14(a)-(b), "[A]n affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3... with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana." (Emphasis added). This is further explained in 45 IAC 3.1-1-111, which states in relevant part:

> The Adjusted Gross Income Tax Act adopts the definition of "affiliated group" contained in Internal Revenue Code section 1504, except that no member of the affiliated group may be included in the Indiana return unless it has adjusted gross income derived from sources within the state, as that phrase is defined in IC 6-3-2-2. For purposes of this subsection, "Adjusted Gross Income derived from sources within the state" means either income or losses derived from activities within the state.
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> IC § 6-3-2-2(a), in relevant part, defines "adjusted gross income derived from sources within Indiana," as

follows:

(1) income from real or tangible personal property located in this state;
(2) income from doing business in this state;
(3) income from a trade or profession conducted in this state;
(4) compensation from a trade or profession conducted in this state; and
(5) income from stocks, bonds, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. **In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana....**

(b) Except as provided in subsection (l), **if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction**, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (3)....

(**Emphasis added**).

Accordingly, when a taxpayer has business income that is earned from sources within and without Indiana, it is only the amount of the business income that is apportioned to Indiana that is deemed to be derived from Indiana sources. Thus, a taxpayer only has business income from Indiana sources to the extent that it has Indiana property, payroll, or sales factors found in IC § 6-3-2-2(b). Therefore, since Sub L has no Indiana property, payroll, and sales factors, Sub L's business income times zero results in Sub L having no income that is derived from Indiana sources.

In Hunt Corp. v. Dep't of State Revenue, 709 N.E.2d 766 (Ind. Tax Ct. 1999), the Department removed three corporations from the taxpayer's return because the corporations did not have Indiana source income, which meant the corporations did not have nexus with the state for adjusted gross income tax purposes. The Tax Court found, as follows:

[Since] neither of the three corporations had any Indiana property, payroll, or sales factors during the tax years at issue.... none of three corporations had adjusted gross income derived from sources within Indiana, a statutory prerequisite to filing a consolidated return. Accordingly, the Department properly removed these corporations from Hunt's consolidated returns.

Id. at 781.

The Tax Court explained:

[W]hen dealing with business income, one does not attempt to determine the source of a particular item of income . Rather, business income is apportioned based on the property, payroll and sales factors of the corporation. See IND.CODE § 6-3-2-2(b) (Supp.1985). Therefore, if a corporation has no Indiana sales, payroll or property, then the corporation has no adjusted gross income derived from sources within Indiana, unless, of course, the corporation has non-business income allocable to Indiana. See id. § 6-3-2-2(a) (Supp.1985) ('In the case of business income, only so much of such income as is apportioned to this state under the provision ofsubsection [6-3-2-2](b) shall be deemed to be derived from sources within the state of Indiana.').

Id.

Accordingly, in Hunt the Tax Court ruled that to be included in the consolidated return the entity would have to have Indiana apportionment factors to have business income from Indiana sources or have nonbusiness income sourced to Indiana.

During the course of the protest, Taxpayer asserted that since the managers of Sub L were the same as the Indiana parent corporation's managers, Sub L had a commercial domicile in Indiana. Taxpayer maintains that Sub L's Indiana commercial domicile created nexus in Indiana. In effect, Taxpayer is asserting that Sub L–which has no payroll, property, or sales of their own in Indiana–can acquire nexus through the activities performed by the managers of it and its Indiana filing affiliates. However, this cannot be the case because of the statutory prerequisite that each entity in the consolidated group have income derived from Indiana sources as provided in IC § 6-3-4-14.

Seemingly, Taxpayer is making an argument that a taxpayer seeking to file a combined return would make in a petition to the Department as provided in IC § 6-3-2-2(l), (q). Under IC § 6-3-2-2(l), if a taxpayer feels "the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for... the employment of [another] method to effectuate an equitable allocation and apportionment of the taxpayer's income." (Emphasis added). However, Taxpayer has not petitioned for a combined return filing, thus, the issue here is consolidated returns.

Consolidated returns only include affiliated entities with Indiana source income. Taxpayer's managers' activities do not show income, Indiana or otherwise, to the excluded entity, therefore, the activities are not eligible for consideration under IC § 6-3-4-14(a) and 45 IAC 3.1-1-111.

B. Sub G.

Taxpayer protests the separation of Sub G from the remainder of Taxpayer's consolidated group. Sub G was formed in late 2007 as an umbrella company for certain foreign operations conducted by Taxpayer. According to the Department's audit, one of Taxpayer's subsidiaries, Sub I, loaned approximately $450,000,000 to Sub G in 2007 to purchase a corporation and that corporation's subsidiaries. Sub I was included as part of Taxpayer's Indiana consolidated income tax return. Taxpayer also loaned Sub G $337,000,000 to purchase a second corporation and the second corporation's subsidiaries.

In 2008, the loans were amended and consolidated into one loan agreement with Sub I. The same day the amended and restated loan agreement was executed, the loan was assigned to yet another entity, Sub S. As part of the assignment of the loan to Sub S, Sub I received "Preferred Equity Certificates" in Sub S. Sub S was not included in Taxpayer's Indiana consolidated income tax return.

Sub G deducted $3,900,000 in interest expense in 2007 and $52,500,000 in 2008. For 2008, Sub I received a $40,000,000 dividend from Sub S. While the dividend from Sub S was included in Sub I's federal taxable income, Sub I claimed a foreign dividend deduction for the $40,000,000 dividend pursuant to IC § 6-3-2-12.

The Department's audit, asserting that the inclusion of Sub G had the effect of not fairly reflecting Taxpayer's adjusted gross income, cited to IC § 6-3-2-2(l) and (m) as its reason for removal of Sub G.

Taxpayer raises two arguments. First, Taxpayer states that the Department was not permitted to remove Sub G from Taxpayer's consolidated income tax return. Taxpayer cites to various cases and statutes, most notably Indiana Dep't of Revenue v. Endress & Hauser, Inc., 404 N.E.2d 1173 (Ind. Ct. App. 1980) and IC § 6-3-1-3.5(b)(9) (addback of certain intangible expenses and related interest expenses).

While IC § 6-3-1-3.5(b) provides the ordinary computation of a corporation's adjusted gross income, a mechanical application of IC § 6-3-1-3.5(b) and related statutes can result in an unfair reflection of income. For this reason, Indiana enacted IC § 6-3-2-2(l) and (m). Even if IC § 6-3-1-3.5 and other provisions otherwise allow particular deductions, income, or exclusions, in certain case, a more appropriate resolution is an alternative calculation permitted under IC § 6-3-2-2(l) and (m). The issue in this case is whether such alternative calculation is justified in Taxpayer's case.

In 2007, Taxpayer and Sub I entered into loan agreements with Sub G. Absent any other transaction, Sub G incurred $3,900,000 in interest expenses and Taxpayer and/or Sub I reported $3,900,000 in income. The full amount of the deduction is offset by the equal and opposite inclusion of income. In other words, Taxpayer fully included the net effect of the loan payments in its Indiana consolidated return. Thus, for 2007 and any income/payments before the May 12, 2008, assignment of the loan(s) to Sub S, Taxpayer has provided sufficient information to conclude that its income was fairly reflected in its returns as filed.

However, for periods on or after May 12, 2008, the effect of Taxpayer's series of transactions was this: First, Sub G reported a minimum of $40,000,000 of interest expense payable to Sub S. Sub G claimed a $40,000,000 (and perhaps greater) deduction. Sub S is not required to file in Indiana; thus, no income is reported to Indiana for this transaction. Second, Sub S paid a $40,000,000 dividend to Sub I. Sub I reported the $40,000,000 dividend as income; however, Sub I also claimed a $40,000,000 deduction under IC § 6-3-2-12.

The net real-world effect is that Sub G and Sub I had zero net income; however, for tax purposes, Sub G and Sub I were reporting a $40,000,000 loss for Indiana tax purposes. Thus, a transaction with a zero net financial effect became a loss due to Taxpayer's own voluntary actions. Under the facts and circumstances of this case, Taxpayer's Indiana adjusted gross income was not fairly reflected by the inclusion of Sub G in its consolidated group. Taxpayer has not raised any alternative methodologies for remedying the lack of fair reflection of its income; thus, Taxpayer's protest is denied with regard to the inclusion of Sub G after May 12, 2008.

FINDING

Taxpayer's protest is denied with regard to the exclusion Sub L. Taxpayer's protest is sustained with regard to exclusion of Sub G for 2007 and for the part of 2008 before May 12, 2008. Taxpayer's protest with regard to the exclusion of Sub G is denied with regard to the inclusion of Sub G on or after May 12, 2008.

II. Corporate Income Tax–Net Operating Losses.

DISCUSSION

Taxpayer protests that the determination of corporate income tax did not consider Taxpayer's net operating losses. In reviewing the protest and documentation provided by Taxpayer, Taxpayer has not provided sufficient information to permit the Department's hearing officer to determine the proper amount of net operating loss deduction available for application–its burden under IC § 6-8.1-5-1(c). Nevertheless, Taxpayer has provided sufficient documentation to permit the Department to review the proper net operating losses available and the application of such net operating losses. The amount of net operating loss available and the application thereof shall be done via a supplemental audit, taking into account any other determination for Taxpayer.

FINDING

Taxpayer's protest is sustained subject to supplemental audit.

III. Corporate Income Tax–Promulgation of Regulations.

DISCUSSION

Taxpayer protests that the Department's proposed assessment violates IC § 6-8.1-3-3(b), which provides that:

No change in the department's interpretation of a listed tax may take effect before the date the change is:

(1) adopted in a rule under this section; or

(2) published in the Indiana Register under IC 4-22-7-7(a)(5), if IC 4-22-2 does not require the interpretation to be adopted as a rule;

if the change would increase a taxpayer's liability for a listed tax.

With regard to Sub L, the Department's interpretation relies on a case decided more than eight years before the years at issue. With regard to Sub G, the Department has not changed its interpretation of IC § 6-3-2-2(l) and (m)–the prerequisite of requiring a rule under IC § 6-8.1-3-3(b). Instead, the case reflects an application of IC § 6-3-2-2(l) and (m) to a particular entity's facts and circumstances. Thus IC § 6-8.1-3-3(b) is not relevant in this case.

FINDING

Taxpayer's protest is denied.

IV. Corporate Income Tax–Estimated Tax Penalty.

DISCUSSION

Taxpayer protests the imposition of penalties for both of the tax years at issue. After review, the penalties were imposed pursuant to IC § 6-3-4-4.1(d), which provides for a penalty for failure to make sufficient estimated tax payments at prescribed intervals during a tax year. In this case, Taxpayer has provided sufficient information to conclude that imposition of the penalty in this case is improper.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest of the exclusion of Sub L is denied.

Taxpayer's protest of the exclusion of Sub G is sustained for 2007 and the portion of 2008 prior to May 12, 2008. Taxpayer's protest of the removal of Sub G for periods on or after May 12, 2008, is denied.

Taxpayer's protest of issues related to net operating losses is sustained subject to audit review of the computation and application of net operating losses.

Taxpayer's protest is sustained with regard to estimated tax penalties.

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